

PRIVATE SECTOR DEVELOPMENT: WHAT WORKS AND WHAT DOES NOT

Michael U. Klein

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CONTENTS

FOREWORD

There is growing realization that state intervention in economic activity does not always produce its desired outcome. Coupled with the collapse of the centrally-planned economic model and increased globalization, this realization has led most developing countries to take steps toward redrawing the boundaries between the state and markets. But not everyone agrees about how exactly to do that. To give but a few examples, there is no consensus about the relative importance of resource availability (human and financial) versus policies and institutions in achieving rapid economic growth, job creation and poverty reduction. Nor is there agreement about whether the state should pick winners and losers, for example, by supporting SMEs or infant industries. Finally, there is no single path for different countries to follow in pursuit of reform.

In this *distinguished lecture,* Michael Klein addresses these issues and makes a persuasive case in favor of the critical role of the policy and institutional environment in determining the outcome of development efforts. He argues that the policy of picking winners and losers is likely to be more costly to society than a policy of promoting competition and safeguarding property rights. When it comes to the appropriate reform path, he points out that the transition has to be country-specific, and that partial reforms are only acceptable if they eventually lead to comprehensive reform.

Besides the elaboration of these views, this edition of the DLS contains, as customary, a summary of the discussion that followed Dr. Klein's presentation at ECES. I am certain that the reader will find them both enlightening and relevant to the ongoing reform debate in Egypt.

Ahmed Galal
Executive Director, ECES
April, 2004

هناك إدراك متزايد أن تدخل الدولة في النشاط الاقتصادي لا يحقق دائما نتائجه المرجوة. وقد دفع هذا الإدراك، إلى جانب انهيار نموذج الاقتصاد الموجه وتنامي ظاهرة العولمة، معظم الدول النامية إلى اتخاذ خطوات نحو إعادة تنظيم العلاقة بين الدولة والأسواق. ورغم هذا التوجه، إلا أنه لا يوجد اتفاق عام حول كيفية تحقيق ذلك. فعلى سبيل المثال، لا يوجد إجماع حول مدى أهمية الموارد البشرية والمالية مقارنة بالسياسات الاقتصادية والمؤسسية في تحقيق أهداف النمو الاقتصادي المتسارع وتوليد فرص العمل والتخفيف من حدة الفقر. كما أنه لا يوجد اتفاق في الرأي حول جدوى اتباع الدولة أسلوب المساندة الانتقائية لأنشطة بعينها، مثل الصناعات الصغيرة أو الوليدة، أو الاهتمام بمناطق جغرافية معينة. وأخيرا، فليس هناك اتفاق حول طريق محدد كي تسلكه الدول في سعيها نحو التنمية الاقتصادية.

وفي هذا العدد من سلسلة المحاضرات المتميزة، يناقش د. مايكل كلاين هذه الموضوعات، ويخلص إلى أهمية توافر المناخ الاقتصادي والمؤسسي الملائم لجني ثمار جهود الإصلاح. كما يرى أن أسلوب المساندة الانتقائية قد يكون مكلفا للمجتمع إذا ما قورن بسياسة تشجيع المنافسة وحماية حقوق الملكية. أما فيما يتعلق بأنسب الطرق للإصلاح، يشير د. كلاين إلى أن عملية التحول يجب أن تراعي خصوصية كل دولة، وكذلك إلى أن جهود الإصلاح الجزئي لا تكون مقبولة إلا إذا أدت في النهاية إلى الإصلاح الشامل.

وإلى جانب عرض تفاصيل هذه الآراء، يشتمل هذا العدد من سلسلة المحاضرات المتميزة على ملخص للمناقشة التي أعقبت محاضرة د. كلاين، والتي عقدت بالمركز المصري للدراسات الاقتصادية. وإنني على يقين من أن القارئ سيجد هذا العدد مفيدا وذا صلة بالحوار الجاري حول مسيرة الإصلاح الاقتصادي في مصر.

د. أحمد جلال

المدير التنفيذي، المركز المصري للدراسات الاقتصادية

إبريل ٢٠٠٤

ABOUT THE SPEAKER

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Michael Klein is the author of *The Private Sector in Development: Entrepreneurship, Regulation, and Competitive Disciplines*. He has published numerous articles on privatization, regulation, and project finance in infrastructure sectors.

Prior to his current position Dr. Klein was the director of the joint Bank-IFC Private Sector Advisory Services from 2000 to 2003. As the chief economist of the Royal Dutch/Shell Group from 1997 to 2000, he advised on worldwide economic developments and industry issues. He joined the World Bank in 1982 as an economist on oil and gas projects, trade and industrial policy, financial sector reform, and macroeconomic analysis. In 1991, Dr. Klein was appointed head of the unit for non-OECD economies at the Economics Department of OECD. In 1993, he rejoined the World Bank and became senior manager of private participation in infrastructure, focusing on issues of market structure, regulation, privatization, and project finance in the telecommunications, transport, energy, and water sectors. Before joining the World Bank, Dr. Klein was active in Amnesty International for many years and served on its German board (1977-79) and International Executive Committee (1979-82). He studied in Bonn, New Haven, and Paris and received his doctorate in economics from the University of Bonn, Germany.

PART I
PRIVATE SECTOR DEVELOPMENT: WHAT WORKS AND WHAT DOES NOT

EXECUTIVE SUMMARY

This analysis suggests a number of approaches countries can take to overcome obstacles to development and poverty reduction. It argues that the key to poverty reduction is creating productive jobs where poor people live. Poverty reduction is not about redistributing the benefits of growth, but about bringing growth processes to poor areas. Poor areas can benefit from technical and organizational innovations made elsewhere in the world, and such innovations mean that today countries can create productive jobs faster and in greater quantity than ever before. The puzzle is what helps spread such "best practices." The paper argues that saving, investment, education, resources, and new technology are all needed, and are all fairly easy to obtain. What is hard to obtain is the institutions that allow these factors of production to be translated into productive job creation.

Some important institutions develop spontaneously, such as basic markets and small-scale trade, and operate even in the most desperate corners of the world, but creating and sustaining large numbers of productive jobs requires a complex web of institutions. The rise of modern firms and contemporary forms of government, both institutions that started in the mid-19th century, provided the critical institutional fabric that allowed factors of production to be combined more productively. To be truly productive, firms need to play by certain rules and be able and willing to cooperate. They need to respect property rights and contracts so that they have incentives to invest and cooperate with buyers and suppliers. They also need to respect a variety of regulations that condition their property rights to ensure that products and production processes adhere to society's expectations about socially and environmentally sound practices. Under such rules, which require government enforcement, firms of different sizes emerge that symbiotically trade and contract with each other.

Firms are the vehicles that spread best practices and productive jobs to areas where poor people live, but firms require certain routines to operate, and those routines may not always be effective or sustainable. Because policymakers can never be sure which firms will succeed, the institutional environment must be such that new firms can enter markets, that substandard firms are allowed to fail, and that good firms face few barriers to growth. This is the definition of competition, and competition is what selects good firms and drives the spread of best practices and productive jobs.

The institutional fabric of societies, which consists of firms, government, and other types of organizations, needs to combine competition and cooperation under agreed rules—a tricky task full of unavoidable tensions. Because the spread of best practices and more productive jobs upsets old patterns of production, it typically disrupts the lives of some people while improving the lives of others, but in the end raises overall living standards. Most governments try to help the process along not just by establishing the basics of property rights and contract security, but also by providing special support to businesses and small farmers and adopting industrial policies that provide businesses and large farms with some protection from competition and easier access to credit. Politically popular, such policies can be effective in overcoming interest groups' resistance to reform, but their contribution to productivity improvements is limited, particularly in situations where the basics of security of property rights and contracts and businesses' freedom to enter and fail are lacking.

An alternative is broader social protection schemes such as social security systems. When sensibly designed, these allow change to occur while providing individuals with a safety net, but countries need productive jobs before they can fund such systems. A basic level of security, however, can also support greater risk taking and thereby enhance the scope for experimentation and change that will eventually result in more productive jobs. Indeed, productive societies have seen a dramatic rise in the extent of government activity in the economy, mostly because of the emergence of state-sponsored social protection. At the same time, a number of countries, notably the Scandinavian ones, have withdrawn from interfering with firms' productive activity.

The right mix of state activity and how it best interacts with firms are not fully understood. Partial reforms can work, but they can also fail. Some mechanism that permits experiments and selects successful ones is valuable for national, provincial, and local governments. Such competition among jurisdictions and firms is an integral part of dynamic social systems that holds promise for creating wealth and ending poverty.

1. Hope and Anger

"First, I would like to have work of any kind."
Eighteen-year old man, Ecuador

The quotation is from *Voices of the Poor*, a World Bank survey that captures the perspectives of poor people around the world (Narayan, Chambers, and others 2000, p. 46). Poor people know what they need to escape poverty. As detailed studies using household survey data confirm, changes in labor earnings and employment status are important factors for escaping from poverty (see, for example, Fields and others 2002). Thus finding a job or establishing a small business is the key.

Just any job or any business will not, however, lead people out of poverty. If poverty reduction were simply a matter of creating jobs, having the state employ everyone would do the trick, as a number of countries around the world have tried to do, notably the communist regimes. The key to poverty reduction is to create productive jobs, and therefore wealth, not just jobs that allow people to scrape by. As an interviewee in Pakistan put it: "The rich have one permanent job; the poor are rich in many jobs" (Narayan, Patel, and others 2000, p. 36). Such jobs and productivity improvements are especially needed where the poor live, which is mostly in rural areas and city peripheries.

The 20th century offered more hope that poverty could be eliminated than any other period in history. Average income per person, adjusted for inflation, quintupled during the century despite unprecedented population growth from about 1.8 billion people to more than 6 billion (De Long 2000). At the end of the century more people lived above the basic poverty line of $1

dollar a day than even a decade earlier (Pfefferman 2000). When using a definition of poverty broader than just income, human development in extremely poor countries such as Mozambique has advanced beyond that in Italy in the late 19th century (Crafts 2000). For the first time in history increases in income do not appear to lead to a Malthusian increase in population. Worldwide fertility rates peaked in the 1960s and population growth has since started to slow (United Nations 2001).

Yet the absolute number of poor people has not fallen, even though their share in total population continues to decline. Advances are heavily concentrated in Asia, particularly China and India. In Africa, however, poverty rates have increased during the last three decades. In Eastern Europe and the former Soviet Union they increased during the decade prior to the fall of communism and faster still thereafter. Nor have two decades of reform in Latin America prevented poverty rates from rising (figure 1). Whether global inequality rose or declined overall during the last three decades of the 20th century remains hotly disputed (Milanovic 1999; Ravallion 2000; Sala-i-Martin 2002). In any case, roughly 1.2 billion people still live on less than $1 a day and 2.8 billion people subsist on less than $2 a day (World Bank 2002b).

Figure 1. Share of the World's Population Living on Less Than $1 per Day, by Region, 1970-98

Source: Sala-i-Martin (2002); World Bank (2000b).

Worldwide the average income per person is about $6,000 a year, equivalent to that in the United States in 1900, then the richest country in the world. This shows that the world can produce enough for everyone to lead a better life; however, many people have not benefited.

Thus the century that gave rise to unprecedented hope also gave rise to anger that many people are still left out. In the words of Nobel Laureate Joseph Stiglitz: "The experience of the past fifty years has demonstrated that development is possible, but not inevitable" (Stiglitz 1998b, p. 5).

2. Ways to Promote Pro-Poor Growth

How can poor people benefit from wealth creation? Today fewer alternative approaches to economic systems are available than at any time since Karl Marx wrote the *Communist Manifesto* in 1848. Some still hope for nonmarket solutions, but they are struggling, as exemplified in a recent speech by João Amaral, a reformist member of the Portuguese Communist Party: "We are not social democrats or market-friendly socialists. Communism means replacing capitalism with something better, even if we do not yet know exactly what that will be" (as quoted in Wise 2002, p. 6). Maybe a completely different economic system will emerge in the future, but for now we have to rely on markets.

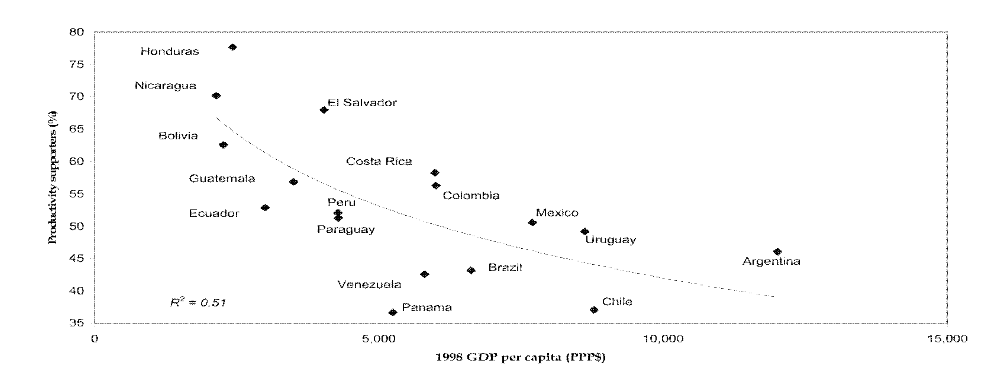
The question thus becomes what pro-poor policies mean in market economies. Some policymakers focus on redistributing incomes. For example, the Basic Income European Network recently proposed a guaranteed basic income for everyone (Williams 2002). The massive redistribution required for such a plan on a global scale would necessitate that economic growth were adequate to fund it. It would also require rich countries' willingness to fund such a plan. Yet the official development aid of all nations amounts to less than $0.15 for each person living on less than $1 a day, and most of that is in the form of debt that countries have to repay. Compare that with what the Republic of Korea (henceforth referred to as Korea) has achieved since the late 1970s: it has generated more income for its citizens from just the manufacturing sector than all the world's development aid combined (figure 2).

Figure 2. A Comparison of Korea's Manufacturing Value Added with Aid to Developing Countries, 1960-2002

Source: World Development Indicators database (available at http://publications.worldbank.org/WDI/).

Even doubling the world's official development aid and transforming all loans into grants would not achieve sustained economic growth in those countries and areas where the poor live. The hope for poor people lies in productivity growth, not in redistribution. Opinion polls in Latin America show that the poorer people are, the more they place their hopes on productivity growth rather than on redistribution (figure 3).

Figure 3. Those Who Believe Productivity is More Important Than Redistribution, By Per Capita GDP, Latin America, 1998



Source: Graham (2002).

Most current debates about pro-poor growth center on ways of providing opportunities to poor people by improving their health and education (World Bank 2002a), offering them access to credit (Morduch 1999; Robinson 2001), connecting them to the global market,[1] helping to create risk insurance schemes, and creating jobs by stimulating overall growth in poor countries and regions (Stern 2001). Deeper understanding of what such interventions can accomplish and how to implement them effectively is required, but the basics are clear: growth processes need to spread to areas where poor people live or to where they can migrate.

3. Drivers of Growth and Job Creation

> "There is a tendency to see development as the accumulation of something necessary. For a while it was infrastructure . . . human capital . . . It has been other things as well. There's obviously truth in those paradigms, but in a deeper sense, societies that succeed in developing are societies where the fairly common individual pursuit of selfish objectives leads to benign social outcomes because of checks and balances in governments, because of enforced private property rights, because of incentives for creativity and entrepreneurship."
>
> *Lawrence Summers (2002)*

Saving, investment, education, natural resources, and new technology are all necessary for growth and relatively easy to obtain. What is needed but is more difficult to obtain is the institutions that allow these factors to be combined and put to productive use.

Accumulation of Capital and Ideas

An understanding of pro-poor growth requires an understanding of growth. Growth requires the accumulation of various types of capital: financial, physical, natural, and human. Most important, humankind's accumulated technical and organizational innovations can, in principle, enable poor countries to catch up with richer ones relatively rapidly, but simply making

[1] See World Bank (2002a) for examples of how information and communications technology is being used to connect producers in low-income or remote areas directly to buyers and to provide producers with access to market- and business-related information.

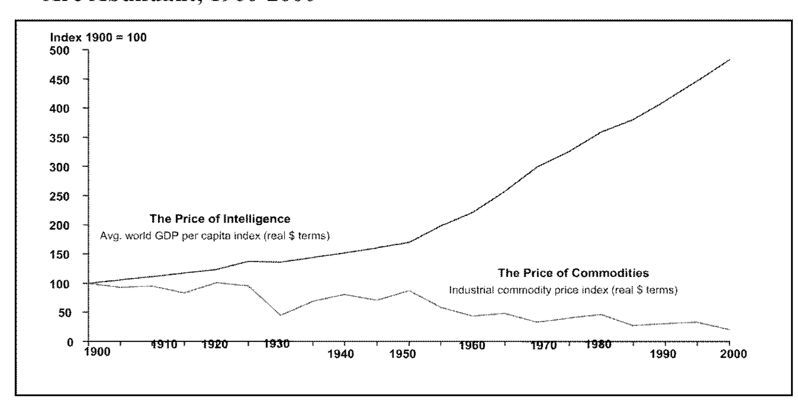
resources and innovations available does not lead to growth (Easterly and Levine 2001; Temple 1999).

Finance. During the 1990s poor countries in Sub-Saharan Africa received capital transfers in the form of development aid that averaged some 10 percent of their gross domestic product (GDP) a year, an extremely high level of inflows relative to the size of these economies. This did not, however, translate into sustained growth. Instead Africa became the region with the highest incidence of capital flight (World Bank 2000a). Estimates reveal that almost 40 percent of private wealth is held outside the region (Collier and Gunning 1999).

Investment. Similarly, high investment rates do not automatically translate into high growth rates. The formerly communist countries offer the most dramatic example: investment rates of 30, or even 40, percent of GDP were among the highest in the world prior to the 1990s, but these countries imploded spectacularly. Hong Kong (China) and Singapore achieved similar growth per person, but Hong Kong (China) did so with significantly lower investment levels (Young 1992). The United States still achieves strong growth with investment rates just below 20 percent of GDP.

Natural Resources. Minerals, fuels, and other agricultural and nonagricultural commodities, remain critical for economies everywhere, but during the 20th century the price of nonfuel commodities fell by four-fifths in real terms, while per capita income grew fivefold (figure 4). Fuel prices have also declined slightly from the high levels reached during the last 30 years largely because of the activities of the Organization of Petroleum Exporting Countries. So despite massive population growth, natural resources are relatively less scarce than would be expected. Nor is possession of resources the key to growth. Botswana, which is rich in diamonds, and Chile, which has abundant copper resources, have benefited from their resource endowments, but the possession of natural resources can also be a curse, for example, some countries endowed with large oil deposits, such as Nigeria, Saudi Arabia, and Venezuela, are not growing much, or are even shrinking (Gelb and Associates 1988; Sachs and Warner 2001).

Figure 4. Intelligence is Scarce, but Natural Resources Are Abundant, 1900-2000



Sources: Economist Intelligence Unit (n.d.): Maddison (2001).

Human Capital. Even investment in education does not easily translate into superior growth (Pritchett 1996). During 1960–85 educational progress in Africa was much faster than in East Asia, but did not result in higher growth. Indeed, overall educational improvements in the developing world during the last 40 years have coincided with declining growth rates. Detailed household surveys also suggest that education levels alone do not explain who escapes from poverty.

Access to Resources and Capital. None of this is to say that finance, investment, natural resources, and education do not matter. They do, but by themselves they are not enough. On the positive side, moving finance into good investment opportunities has become easier; countries have lowered their trade barriers, making capital goods that embody new technologies more readily available; and the education levels needed for income growth in poor countries do not appear to be too difficult to achieve.

Diffusion of Ideas and Growth of Income. Technical and organizational innovations have led to an unprecedented creation of wealth (see box 1). The advantage of innovations is that unlike physical objects, if they can be communicated they can be used over and over again (Romer 1993). This characteristic of ideas is what allows poor countries to raise incomes much faster today than ever before.

Box 1. The Speed of Wealth Creation

Before the 18th century per capita income grew extremely slowly. When populations grew, their growth risked offsetting any progress, just as Malthus argued at the beginning of the industrial revolution. For incomes to double in pre-industrial Europe took some 350 years, but in the run-up to the industrial revolution per capita incomes started rising much more rapidly. For example, in the 19th century the United Kingdom, then the world's richest country, was able to double per capita incomes in 65 years, and at that time no other country could rival its performance. By the second half of the 20th century, however, a whole range of countries, including Botswana, Chile, China, Ireland, Japan, Korea, and Thailand, were able to grow for sustained periods at rates that doubled per capita income in about 10 to 15 years.

Source: Cameron (1991); Crafts (2000).

For the first time in human history large numbers of people can escape from poverty within a life span. Today people in poorer countries can make use of new technology, new learning, and better ways of doing things that were developed in more advanced economies. They can learn from organizational innovations in both firms and governments. Openness to learning from other countries—or from growth centers within a country—is therefore critical for rapid income growth and poverty reduction.[2]

The diffusion of ideas has also become easier. Many more ideas are recorded, and the means for communicating them have become faster, more efficient, and more ubiquitous. Ideas might not move quite as easily as finance, but people can acquire new ideas embodied in imported machines, buy technology licenses, study at home or abroad, and use the Internet. Korea shows that acquiring new technology and ideas from overseas is fairly cheap: it spent less than 1.5 percent of the increase in its GDP during 1973–79 on the technology licenses that underpinned its manufacturing growth (Olson 1996).[3]

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[2] Note that the static efficiency gains derived from trade liberalization cannot explain the main benefits of openness. Static gains from trade are typically one-off benefits on the order of 2 percent of GDP, or maybe 4 to 6 percent of GDP in the presence of product differentiation or economies of scale. These are important, but not nearly as important as the gains from learning that drive successful growth processes.

[3] While innovators can earn a fair amount of money, they rarely receive the full rents from their innovation. For example, Thomas Edison received but a fraction of the benefits that electric light created. Even patent protection, unless extreme, on average just affords innovating firms with a normal rate of return on the cost of their inventions.

Impediments and Traps

If the provision of capital does not drive growth, if finance, capital goods, and know-how are not hard to obtain, why is growth difficult for some countries to achieve? One set of arguments concerns a variety of traps or lasting impediments that prevent countries from growing rapidly. They may suffer from being small, landlocked, or plagued by inclement climates (Gallup, Sachs, and Mellinger 1998). They may be enduring ethnic strife or civil war (Collier 2000; Collier and Gunning 1999). They may have policy and institutional rigidities induced by vested interests (Acemoglu and Robinson 2000; Havrylyshyn and Odling-Smee 2000; Hellman 1998). They may suffer from cultural biases or a lack of trust, a critical part of social capital (Collier 1998; Fukuyama 2000).

Whatever the trap, some countries have been able to escape from it. All of today's industrial countries have emerged, eventually, from hopeless situations. At the time of the Thirty-Year War (1618–48) who would have thought that Germany would ever be an economic powerhouse?

Today many countries have escaped from their traps fairly rapidly by historical standards. Consider the following examples:

- *Countries can overcome adverse climatic conditions.* Tropical Singapore is a rich country, and Malaysia and Thailand have also performed well, as did Venezuela during most of the 20th century until the curse of oil set in during the late 1970s. At the other end of the climatic spectrum the Scandinavian countries boomed during the 20th century, including isolated, inhospitable Iceland.[4]
- *Remote location need not prevent development.* Landlocked, tiny Botswana has consistently been a star performer in recent decades. Since the late 1980s landlocked Uganda has emerged rapidly from its days of civil war and dictatorship and experienced strong growth in the 1990s. The tiny island of Mauritius became one of Africa's best performing economies.

[4] One hundred years ago Iceland had virtually no free-standing houses and people lived half underground in grass-covered huts.

- *Recovery from civil strife is possible.* Civil war ended in El Salvador in 1992. Six years later per capita income had increased by 17 percent and the country's human development index was up 8 percent, all without increasing its debt burden. Indeed, El Salvador became the third country in Latin America to receive an investment-grade bond rating in 1998, even before Mexico.
- *Countries that languish for decades can turn around.* Ireland, which suffered decades of emigration and economic stagnation, overtook the United Kingdom in per capita income in the 1990s driven by productivity growth from foreign investment.
- *Countries can even overcome deeply entrenched dysfunctional institutions.* Several countries, constrained by a formidable set of growth-restraining institutions, policies, and vested interests, turned around within a decade, particularly China and formerly communist countries in Central Europe.

The enrichment of many countries has demonstrated that some may run into traps at higher incomes. Argentina, once among the most advanced countries in the world, has stagnated relative to other countries since the 1930s. Stagnation could also befall Japan. Those communist countries that grew during the early phases of industrialization are the most dramatic illustration of the phenomenon. We do not know how to predict such cases, but apparently after initial success, some countries' development may be arrested for some time.

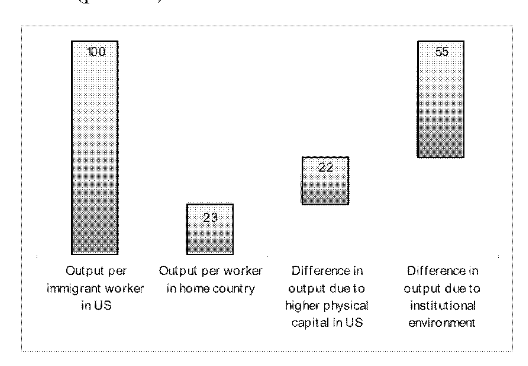
Overall, while many countries have emerged from traps, many others have not or are getting trapped again. The upshot is that a variety of factors can make development hard for a country, but in principle they can be overcome, often in a fairly short time. What it takes to do so is the issue.

Capable Institutions as the Key to Development

One way to reduce poverty is to allow poor people to move to richer countries. Immigrants to the United States produce over 4.5 times more there than in their countries of origin, yet their skill level is the same. They benefit from extra and more advanced physical capital in the United

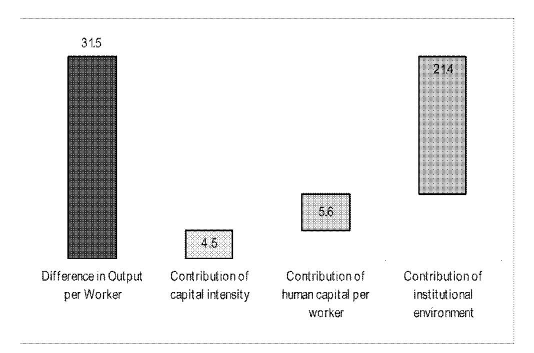
States, but that explains only about a third of the difference (figure 5). The main explanation is the capability of institutions—be they firms or governments—that allow individuals to perform at higher levels of productivity.

Figure 5. Contribution of Factor Accumulation and the Institutional Environment to Income Differences, 1990 (percent)



Source: Based on Hendricks (2002).

Figure 6. Contribution of Selected Factors to the Difference in Output per Worker, 1988 (ratio of the five richest to the five poorest countries)



Source: Based on Hall and Jones (1999).

Hall and Jones's (1999) review of output in 127 countries indicates that human and physical capital differences account for only a modest amount of the difference (figure 6). The biggest factor remains hard to capture. The study concludes that the remaining productivity residual is driven by differences in the institutional environment. Having large unexplained residuals in statistical studies of growth for particular countries is not a new phenomenon (Denison 1967; Solow 1957), but a comparison of productivity across countries shows the full extent of the elusive unexplained residual.

Various factors have to come together to raise productivity and incomes. For example, the more open an economy is—and presumably the greater its ability to learn—the more education becomes useful (Krueger and Lindahl 2001; Lopez, Thomas, and Wang 1998). Similarly, the higher the level of domestic education, the more productive foreign investment becomes (Borenzstein, De Gregorio, and Lee 1994; World Bank 2001a). All this points to the power of institutions that enhance the division of labor.

Productivity also differs among regions within countries. Consider the coastal and interior provinces in China or the northeast of Brazil compared with Sao Paulo. Even where labor is mobile and goods, services, and capital can move freely, significant productivity differences can persist. Putnam's (1993) study of Italy suggests that long-standing differences between Italy's north and south reflect differences in trust among people based on enduring patterns of behavior, what the author calls "social capital." In short, the environment people operate in affects their productivity.

Cities tend to be more productive than other parts of a country. More ideas are generated there, and incomes are higher because cities allow for flexible labor markets, work arrangements, production, and subcontracting methods and permit easier flows of ideas. Figure 7 illustrates this with reference to new product innovation in the United States.

Figure 7. Location of New Product Innovation, United States, 1996 (percent)

Elsewhere 4 %

New York, Los Angeles, Boston, San Francisco 45 %

Other metropolitan areas 51 %

Source: Glaeser (1998).

Clusters of firms as in Silicon Valley (information and communications technology) and in northern Italy (textiles and garments) provide benefits similar to those in cities (Porter 1998). According to executives in Silicon Valley: "People change jobs without changing carpools," and "The network in Silicon Valley transcends company loyalties. We treat people fairly and they are loyal to us, but there is an even higher level of loyalty to their network" (Saxenian 1996, pp. 35, 36). Cities are forms of clusters.

Large, multiplant firms, which exhibit some features similar to those of clusters, such as flexible internal labor markets, loyalty to the larger firm, and flexible internal contracting, are more productive than smaller ones (Sutton 2000). In many developing countries foreign firms are more productive than local ones, which suggests one route for importing some types of capabilities.

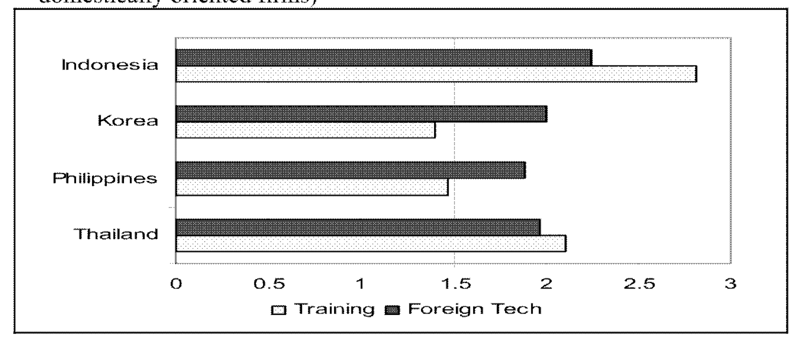
Most important, firms spread best practices, and therefore wealth, through channels within countries as well as across national boundaries. Studies of cross-border links between firms have attracted more attention than studies of links among firms within countries. Hence some of the discussion in the next paragraph tends to focus on international learning channels; however, the same or similar mechanisms are at work within countries.

One way to improve firm-level performance is for more productive firms to move into new markets through new investments or through mergers or acquisitions. When this takes place across borders it is referred to as foreign direct investment. Foreign firms and joint ventures with foreign firms typically exhibit higher productivity than local firms in developing countries (Barberis and others 1996; Blomstrom and Sjoholm 1998; Djankov and Murrell 2002; Earle and Estrin 1998; Havrylyshyn and McGettigan 1999). Foreign firms employ mostly local workers and managers, training them on the job in new technical and organizational practices. The superior performance of foreign direct investors tends to provide them with greater market share in their sector. Over time, local competitors may be able to catch up, but initially they tend to lose market share (Aitken and Harrison 1999; Djankov and Murrell 2002). Similar processes are at work within countries: efficient companies from one part of a country move into other regions and improve productivity there.

Subcontractors to foreign investors appear to be helped by their presence. Dealing with demanding foreign investors helps them upgrade their quality and reduce their costs. In varying degrees foreign investors provide active support to their suppliers to improve the suppliers' performance (Batra and Tan 1995, 2000). Contracting also takes place across borders. Export opportunities provide competent domestic firms with the option of upgrading their productivity.

As studies of firms from East Asia suggest, firms that target export markets make appropriate investments in training and technology that raise their productivity (figure 8). Demanding customers in high-quality markets are a key force driving performance improvements.

Figure 8. Investment in Training and Foreign Technology, Selected Asian Countries, 1996-99 (ratio of expenditure by exporters to expenditure by domestically oriented firms)



Note: Data from surveys conducted over period 1996-99.
Source: Hallward-Driemeier (2001).

Another important way for new and more productive firms to emerge is for people who have acquired knowledge in one firm to leave that firm and set up their own enterprises. One example is the garment industry in Bangladesh, where locals learned from a Korean company, Daewoo (see box 2). Eventually they set up their own businesses in Bangladesh, which in turn produced more small entrepreneurs. Relatively quickly the garment industry became Bangladesh's leading export industry, and by 2001 accounted for almost 75 percent of the country's export earnings. Similarly, India's most efficient machine tool company was set up by four machine tool design engineers who had left the employment of an old and inefficient state-owned firm. The new firm became a major supplier of machine tools by specializing in the production of a narrow product line and by embarking on a competitive pricing policy. The key to the firm's success was its flexible and efficient management (Sutton 2000).

Box 2. Diffusion of Good Practices and the Growth of the Garments Industry in Bangladesh

Bangladesh's garment industry grew from nothing in 1979 to about $5 billion of exports per year by 2003, accounting for slightly more than three-quarters of the country's annual export earnings. This phenomenal growth was due to the diffusion of good practices from one foreign company to one local enterprise and from the local enterprise to many other local firms. It was also due to a number of policy and administrative improvements that opened up investment opportunities for local entrepreneurs.

In 1979 the Korean company Daewoo and the Bangladeshi enterprise Desh Garments entered into a collaborative agreement. Daewoo did not make any capital investment in Desh, but signed a five-year contract to help Desh purchase machinery and fabric (some of it on credit from Daewoo), to set up Desh's factory, to market the garments, and to train Desh's employees at Daewoo's plant in Korea and at Desh's facilities in Bangladesh. About 130 Desh employees received intensive training in technical production skills, management, and marketing in Korea. They returned to Bangladesh with this knowledge plus an appreciation of the corporate culture required for success in export markets. Daewoo sent its own technicians to Desh to help set up the machines, oversee quality assurance in production, and train Desh workers who had not been to Korea.

Garment production began at Desh's plant in 1980 with 450 machines and 500 workers. The following year Desh's management believed that the company was ready to operate on its own and terminated Desh's contract with Daewoo. In 1980 Desh produced 43,000 shirts worth $56,000. By 1987 sales had risen to 2.3 million shirts worth $5.3 million. The quality of Desh's garments had also improved significantly. The unit export price increased by 75 percent from $1.30 to $2.30. Between 1980 and 1987 Desh expanded from 450 machines to 750 and its workforce increased to 1,400. Throughout this period Desh was handling its own export marketing and was buying all its raw materials from sources other than Daewoo.

Of the initial batch of 130 employees who had visited Korea in 1980, 115 had left Desh by mid-1981 to start their own garment exporting businesses and began replicating Desh's success in other factories. By 1985 Bangladesh had 700 manufacturers engaged in garment exports.

Source: Mahmood (2002).

Many successful small companies are founded by former employees of larger companies, where they learned their jobs. Often they learn about opportunities that their previous employers do not recognize or do not wish to exploit. Former employers might have been stuck in routines that were too hard to change or their employers might have been reluctant to embark on new ventures that would have undermined or cannibalized successful product lines (Christensen, 1997). The most detailed attempt at studying the phenomenon comes from the United States, where in 1989 a survey of 500 company founders indicated that more than 70 percent of new ventures were set up by employees who got their business ideas when employed by another company (figure 9).

Figure 9. Origins of Innovation, United States
(percentage of 1989 Inc. 500 founders surveyed)

Idea came by accident 5%
Idea came through research 4%
Idea came through experimentation 20%
Idea came from previous employment 71%

Source: Bhidé (2000).

The Adoption of Best Practices and the Creation of Capable Institutions

Critical to reducing poverty or creating wealth is the capability of institutions that allow people to work together and that create productive jobs in the process.[5] For poverty to be eradicated quickly, these institutions must be open to learning and adapting know-how that already exists and be capable of applying it efficiently. According to Harberger (1988, p. 27):

> If, as I believe, the difference in efficiency between U.S. and developing-country firms is typically large, there is much room for quite rapid improvements in the developing countries as they learn how to adopt and adapt already-known techniques from the advanced countries.

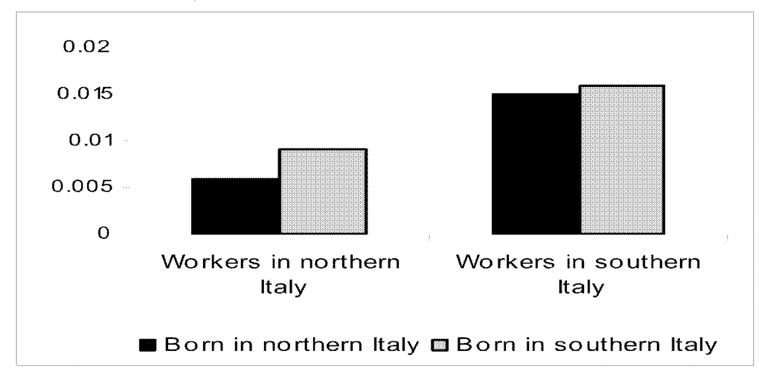
The traditional factors of production—natural resources, capital goods, finance, ideas, and reasonably competent labor—are not hard to obtain, but because poor people cannot simply move to areas where capable institutions already exist, pro-poor growth involves diffusing best practices and capabilities to areas where poor people live. As Wade (2002, p. 17) notes, “The engine [of development] is the advance of technology and the diffusion of technical capacities of people, firms and governments.”

Countries can learn the mechanics of organizing institutions. For firms, organizational

[5] Whether referred to as poverty reduction, wealth creation, or growth, a widespread rise in individual incomes requires productivity improvements and the provision of better products or services, because standards of living improve when people can acquire existing products or services at lower costs or better ones at acceptable costs.

practices can also be imported through foreign direct investment or the movement of firms within countries. The critical local element of good institutions that is hard to import is people's ability to work well together, that is, their behavior and culture. Even firms cannot transplant cultures. A study of a large firm in Italy with operations in both the north and south of the country shows that workers' behavior varies significantly in different parts of the country. When workers from the north move south, they start behaving like southern workers and vice versa (figure 10).

Figure 10. Frequency of Worker Misconduct in an Italian Firm, by Region of Birth, 1975-95 (ratio of the number of observations for which at least one misconduct episode was recorded to the total number of observations)



Source: Ichino and Ichino (1997).

4. The Core Institutions of Markets, Firms, and Governments

"Trying to stop a market is like trying to stop a river."

Vietnamese proverb

"A nation's economic growth and competitive strength rest on more than natural resources, labor and managerial skills, available capital or even the size of internal markets. The wealth of nations during the past hundred years has been based more on the ability of industrial enterprises to adopt and to develop . . . technologies and to devise administrative structures to co-ordinate the . . . processes of production and distribution."

Alfred Chandler (1997, p. 63)

> "What distinguishes modern government from personal control is its unremitting character. To be governed is to be subjected to the regular pressure of an authority operating to fixed rules . . . In the full sense of the word, it is arguable that nobody was governed before the later 19th century."
>
> *Jean Dunbabin (quoted in Finer 1997, p. 70)*

Markets are institutions that arise spontaneously even without government intervention. In the most desolate places merchants ply their trade and supply people with goods and services. Lawless places like Somalia demonstrate that trade in almost all goods at world prices can be organized in the absence of government. Even cell phone service with prepaid cards is available in Somalia, as is basic electricity service—for those who can pay. Tiny enterprises and farms operate in all societies (McMillan 2002).

Substantial and sustained wealth creation requires a complex division of labor and more complex organizations than arise spontaneously. The rise of modern firms operating in markets shaped by modern governments provides the institutional fabric for factors of production to combine more and to do so more productively. To be productive firms need to play by certain rules and be able and willing to cooperate. They need to respect such basic rules as property rights and contracts so that they have incentives to invest and cooperate with buyers and suppliers. To ensure that products and production processes fit society's expectations about socially and environmentally sound practices firms also need to respect a variety of regulations that condition their property rights. Under such rules, which governments must establish and enforce, a symbiosis emerges, with firms of various sizes that compete, trade, and contract with each other.

Experiments and Routines

Firms spread best practices and productive jobs to areas where poor people live, but this diffusion is not straightforward. As discussed earlier, various channels for improving firm-level performance are available that transfer best practices already developed elsewhere; however, not all firms are capable of benefiting from them, even when governments permit new firm entry and

when firms are open to new methods of organization and production. Two fundamental reasons account for this. First, all entrepreneurial activity is fraught with uncertainty and therefore requires experimentation. Second, like any other organizations, firms need to create routines to cope with complex tasks. Thus failure is unavoidable for those firms that make the wrong bet or choose unsustainable routines.

Even simple production technologies, such as planting new farm crops, require adaptation to local circumstances. More complex technologies, such as automobile manufacturing, require extensive learning on the job. Korea's Hyundai corporation undertook 14 months of trials to design its first prototype automobile. It then experimented with 11 prototypes, 2,888 engine design changes, 97 test engines, and more than 200 test transmissions and 150 test vehicles to produce its first commercial car in 1992 (Kim 1997).

In relation to routines, consider the Indian machine tools industry, which shows that the staff of mediocre firms could do much better than the firms they worked in. Management may not have listened to them, may not have given them a chance, or may have been unable to restructure existing operations. The old companies were stuck in routines that prevented them from improving.

Routines are unavoidable, but different ways of pursuing a productive activity are often available. Even in everyday life people benefit from routines that simplify their tasks, and routines are even more important when aligning work practices in a firm. Routines are not bureaucratic aberrations, but are a way of coping with complexity; however, they may fail to deliver.

Competition

The main reasons that firms fail are information problems, uncertainty, and limited ability to cope with complexity. So for firms to adopt best practices mechanisms must be in place that deal reasonably well with the failure of firms. Such mechanisms need to allow physical assets, ideas, people, and funds to be used again in new and better ways when a firm fails. This is where the competition in markets comes in. Competitive markets select firms that pursue particular

experiments or routines. They also provide incentives for market participants to improve and to adjust when they are facing failure. In some cases incumbent firms adapt successfully. In others new entrants drive out nonperforming firms.

Over the last 20 years researchers have undertaken considerable work in attempts to reach a better understanding of the way markets with firms work. Most of this work looks at the industrial countries (Caves 1998; Sutton 1997; Tybout 2000), but a significant amount of work has also been carried out in the developing countries.[6] The picture is similar in both industrial and developing countries, with the main difference being that developing economies tend to have a higher proportion of smaller firms than industrial economies (figure 11).

Figure 11. Distribution of Employment by Firm Size, 34 Selected Countries, 1985-88



Note: Data based on survey of 34 countries, GNP per capita data are from 1980-95.
Data on number of employees are based on industrial censuses conducted in the 1960s and 1970s.
Sources: Hallberg (2000); Snodgrass and Biggs (1996).

Heterogeneity among Firms. Traditional economic textbooks treat markets as if all firms are efficient, driven by the incentives from the price signals in markets. When demand increases new firms would enter, and when it decreases some incumbents would fail. In reality the picture

[6] See also Audretsch (2000), Aw (2002), Nugent and Yhee (2002), Snodgrass and Biggs (1996), and the World Bank's Africa Regional Program on Enterprise Development microstudies for Africa over the last decade (available at

is quite different. Typically existing firms are not similarly efficient. Instead they are quite heterogeneous, with substantial dispersion in productivity among firms and among sectors. Harberger's (1998) detailed review of firm-level performance in 44 different manufacturing sectors in Mexico shows that in each sector some firms add value, some barely contribute, and others destroy value. The average productivity of firms in different sectors in India varies substantially and remains significantly below their potential productivity (figure 12).

Figure 12. Actual and Expected Labor Productivity, India, 1998 and 2010 (indexed to the United States, 1998 = 100)

Note: Figures for expected productivity are derived on the assumption that all productivity barriers are removed. Most of the productivity improvements are expected to come from rationalizing the workforce, improving the organization of functions and tasks, and investing in viable assets.

Source: McKinsey Global Institute (2001).

Competition and the Dispersion of Productivity. In general, bringing average practice closer to best practice is enormously valuable for wealth creation. Individual firms often have similar opportunities to learn and improve, but fail to do so for the reasons cited earlier. Competition is key to bringing average practice closer to best practice, hence competition is a critical part of the mechanism for diffusing best practice. A number of studies support this for countries such as Brazil, India, Korea, Japan, Russia, and Thailand (Hallward-Driemeier 2001; McKinsey Global Institute 1994, 1998a, b, 1999, 2000, 2001, 2002).

http://www1.worldbank.org/rped/index.asp).

Entry and Exit Patterns. The key element of competition is the freedom to enter the market and to fail. Free entry means that substandard enterprises must be able to exit from markets. Where inefficient but politically well-connected firms are sustained through protection by or subsidies from governments or through bailouts by financial institutions, new firms can compete only with difficulty. Under such circumstances obtaining credit is hard, and new firms tend not to enter.

When entry is possible, new firms do not enter only when demand is up and old firms do not leave only when demand declines. Every year around 5 to 20 percent of all firms enter the market and a similar number of older firms go out of business. Most new firms are small, and some 40 to 60 percent go out of business within five years of entering (Scarpetta and others 2002; figure 13). Data from developing countries suggest that the average new entrant is slightly more productive than the average firm exiting the market. Thus in most economies the turnover of firms helps increase productivity. In part this reflects people who have previously failed being successful. In part it reflects new entrants altogether.

Figure 13. Plant Turnover and Market Share of Entrants, Selected Countries

One-year-old plants

Five-year-old plants

Percent

Chile Colombia Morocco

Korea Taiwan United States

Market share of entrants Plant turnover rates

Note: The plant turnover rate is the average of the entry rate and the exit rate of plants.
Source: Tybout (2000).

Opportunities for Small Businesses and Farms. Many of the key measures to help small farms and microenterprises are much the same as those aimed at other firms. De Soto has demonstrated both in writing (De Soto 2000) and in his experiments with setting up new small firms that burdensome entry regulations, red tape, and bureaucratic harassment, along with the

absence of clear property rights and contract security, make it impossible for many small entrepreneurs to establish themselves, become formal, and grow. This spotlights the importance of programs to reduce entry regulations, reduce bureaucratic harassment, and clarify and formalize property rights (see box 3).

Box 3. Property Rights and Poverty Reduction

The total value of the fixed property the poor in developing countries hold but do not legally own is around $9.3 trillion. This is 93 times the amount of official development assistance to developing countries over the past 30 years and 20 times the stock of foreign direct investment in developing countries between 1989 and 1999. Because the ownership of these assets is not formalized, however, people in poor countries cannot use them as collateral to raise cash.

Field research has shown that the reason why businesses stay informal and landowners do not register their property is not only because they have to pay taxes, but because the bureaucracy usually hinders them in their attempts to do so. For example, De Soto and a team of his researchers tried to register a one-man clothing workshop that they had set up outside Lima, Peru. It took 289 days, including many hours of filling out forms, traveling by bus into central Lima, and lining up to see the relevant officials to register their microenterprise. The whole undertaking cost $1,231—31 times Peru's monthly minimum wage.

In Malawi people build houses on "customary" land, that is, land that the residents have no formal title to, but that their families have cultivated for generations. The village chief usually oversees any disputes about boundaries. If a family breaks the tribe's rules or leaves the property unattended, the chief has the power to take the land away and give it to someone else. The contract may be oral, or it may be written and signed by the chief. The problem is that no bank will accept it as collateral. The land and the property built on it turn out to be what De Soto calls "dead" capital.

All the rich, industrial countries have clear, enforceable, and almost inclusive property rights. Even though better property laws are not the only reason why some countries are better off than others, De Soto finds that they make a significant difference.

Source: De Soto (2000).

Internal Growth. Productivity growth comes not only from enterprise entry and exit, but also from the growth of existing firms responding to market incentives. Some of the new entrants succeed and the best become large firms (Rajan and Zingales 1998). Productivity growth also comes from large firms branching out and entering new markets, sometimes through mergers with and acquisitions of promising firms. As good firms become large they tend, on average, to have higher productivity than small firms, but small companies that happen to be particularly efficient exhibit the highest growth rates. Firms are productive not because they are a particular size, but because they are good (Aw 2002).

In a new industry small firms play the prime role in innovation and productivity development (see box 4). The good firms continue to improve through internal growth, taking over less well-managed companies or buying up promising small firms that need capital (Ravenscraft and Scherer 1987). Once firms have proven themselves and become large, they remain more productive and last much longer than the average smaller firm. Indeed, many large firms are like collections of small ones. They operate an internal market for corporate control, which can be superior to that of the broader market, and they owe their success to their ability to allocate people, capital, ideas, and assets better than firms operating at arms-length from each other (Hellwig 2000; Klein 2000). Nothing is guaranteed, however, and large firms may also fail eventually.

Box 4. Markets, Innovation, and the State

In the 1920s and 1930s pilots flew around 100,000 different varieties of airplanes. All over the world enthusiastic inventors were selling airplanes to intrepid pilots and to fledging airlines. Many of the pilots crashed, and many of the airlines became bankrupt. Of the 100,000 types of airplanes about 100 survived to form the basis of modern aviation. The evolution of the airplane was a strictly Darwinian process in which almost all the varieties of airplane failed, just as almost all species became extinct. Because of the rigorous selection, the few surviving airplanes are reliable, economical, and safe.

Source: Dyson (1998).

Symbiosis of Large and Small Firms. All sectors in all market economies have a mix of many small, fewer medium, and a few large companies. The average size varies with economies of scale between sectors, but firms of many different sizes are found within sectors, not like in the textbooks that suggest that all firms in an industry should look similar, reflecting relevant economies of scale. Small, medium, and large firms do not just exist alongside each other in markets. They also interact through buyer-seller relationships, through various cooperative arrangements, and through credit relationships. Many types of intricate networks of firms exist, within large companies, between large and smaller ones, and in clusters of various types. The way that a firm enters, grows, and exits varies from country to country, an area little studied so far. A recent Organisation for Economic Co-operation and Development (OECD) study (Scarpetta and others 2002) shows that the average new entrant in the United States is less

efficient than existing firms, but entry is valuable because it allows people to try out new ideas, and the companies that turn out to be good can easily grow to become larger. Most productivity growth in the United States is therefore due to the internal growth of firms and not to the entry of more efficient firms, but in several European countries the entry of better firms accounts for a large part of productivity growth and internal growth appears to be less effective. This may reflect barriers to growth in those countries, such as labor regulations for firms above small sizes (figure 14). In developing countries extremely small, informal enterprises proliferate, and prefer to remain informal because of the burden of regulations and taxes on formal firms.

Figure 14. Contribution of Selected Factors to Productivity Growth in Manufacturing, Six Industrial Countries

Source: Scarpetta and others (2002).

In the ecology of firms, markets leave ample room for new organizational species to emerge, which could include atomistic small firms, large hierarchical firms, internal firm markets for corporate control, and all sorts of cooperative arrangements among firms. Customer demand provides the main feedback mechanism, as those firms that meet customer demand most effectively are the ones that survive. The diffusion of best practice is accomplished within this well-functioning ecology, not by any single measure or any single type of firm. Governments shape the ecology and the niches allowed by the way they set property rights, regulations, taxes, and other relevant parameters.

5. Market Failure and the Politics of Change

In relation to generating growth or establishing competitiveness, special government support beyond allowing the ecology of firms to work is often justified in the case of market failures that may affect learning processes and access to finance. Learning needs time, hence proponents of protection argue that certain sectors that have the potential for growth might need some kind of temporary protection until they are ready to face the onslaught of full international competition. To some extent learning is also embodied in individuals. When firms spend resources to train individuals the latter might decide to leave and reap the benefits for themselves, which could make firms overly reluctant to invest in training.[7] In relation to access to finance, financial institutions may be unwilling to lend to small and medium enterprises because they have little track record; are likely to go bankrupt within a few years; and are typically dependent on a single owner or just a few persons, who might be affected by illness or other sudden adverse events.

Large Firms as Institutions for Coping with Market Failure

Special institutional innovations are needed to cope with such market failures. The larger firm itself is precisely such an institution. Indeed, it is the first line of defense against market failure. It is capable of building a track record that will satisfy financial institutions, it is less dependent on individuals than smaller firms, it can invest in small subsidiaries while they learn, and it is more likely to retain staff (because of the broader range of employment opportunities and career advancement than in small firms) and benefit from investment in training.

Collateral and Credit Information Systems

As a second line of defense, governments can help with access to credit by establishing functioning property rights systems that allow collateral systems to function so that individuals and small firms can obtain access to credit (Fleisig 1995). For example, small enterprises can

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[7] Smaller firms, in particular, can overcome the problem of incentives to train as long as they are able to employ apprentices at extremely low wages as happens in a number of countries. Many people may then choose to learn at low wages in small firms in the expectation of higher incomes later rather than taking on an initially better paid job elsewhere that will yield a lower lifetime income. Where labor regulations prohibit low wages for apprentices, small firms may not have the right incentives to invest in training.

secure finance through mortgages on the enterprise owner's real estate. Credit information systems that help track the payment records of individuals and small firms are another key mechanism to help small market participants establish their credit, and hence obtain access to finance.

Support Programs for Small and Medium Enterprises and Farmers

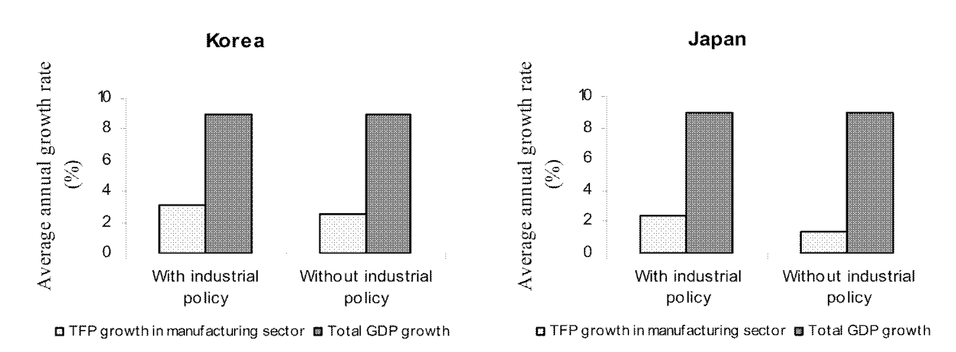
Beyond these basic measures, on which consensus is relatively widespread, governments can establish additional programs to support small and medium firms. Most countries have directed and subsidized credit programs for small urban and rural enterprises and farms. Advisory services for farms and small firms, for example, on new crops or farming techniques or on business management, are also widespread. The most complete review of studies on experience with such schemes worldwide suggests, however, that few schemes have been properly evaluated (Batra and Mahmood 2001). Overall, many are ineffective or are abused, especially subsidized schemes. The key conclusion that emerges from experience is that the schemes with the greatest chance of working well are those that are aligned with basic market principles. For instance, good credit support programs tend to avoid subsidized credit terms, and sound approaches to advisory services tend to emphasize the creation of demand for such services and delivery via market mechanisms. In addition, special support schemes seem to require a sound, basic, overall policy framework for markets where they operate.

Industrial Policy

Special government support for domestic firms of all types has typically been referred to as infant industry protection or industrial policy, even though such support might also affect other sectors, such as services or agriculture. Essentially industrial policy consists of a mix of policies that create room for domestic firms to learn and to obtain finance so as to improve productivity. In many countries such policies have been a disappointment. The case of the Indian machine tool industry cited earlier provides an example, where a protected industry did not use protection to learn, but was satisfied with substandard performance. Supporters of industrial policy argue that in East Asian economies like Japan and Korea, industrial policy has often helped. Pack (2000)

examines productivity performance in Japan and Korea sector by sector and finds that the sectors that benefited from special support contributed only a modest amount to productivity growth (figure 15). Thus overall, even in the two arguably most successful cases of industrial growth, industrial policy has at best been a small factor in their success.

Figure 15. Effect of Industrial Policy on the Growth of Total Factor Productivity in the Manufacturing Sector and on GDP Growth, Korea 1966-85 and Japan 1960-79



Note: This analysis is based on the assumption that growth in the manufacturing sector accounted for only one-third of the growth in GDP in both Korea and Japan. The total factor productivity growth figures relate to the manufacturing sector only and not to the whole economy.
Source: Pack (2000).

Clearly, to be successful industrial policy needs to expose those firms that are supported to some form of serious competition, for example, by tying continued support to export success in truly competitive markets as in the case of Japan and Korea (Stiglitz 1998a). If government intervention is to help, firms must be open to best practices and exposed to the selection mechanism of competition. Even analysts who question economic orthodoxy and are open to heterodox approaches conclude that "we do not want to leave the impression that we think trade protection is good for economic growth. We know of no credible evidence—at least for the post-1945 period—that suggests that trade restrictions are systematically associated with higher growth rates" (Rodriguez and Rodrik 2000, p. 317).

Politics of Support Schemes

Whatever form of intervention in support of access to finance or learning governments may consider for small and large firms, in urban or rural areas, basic market forces are apparently

needed to give these policies a chance to succeed. Perhaps such interventions work in places where otherwise sound institutions and policies are in place anyway.[8] Note that in connection with such successful special schemes as export promotion, industrial policy, and the like, the same small group of countries is mentioned again and again, especially Japan, Korea, and Singapore (Keesing and Singer 1990; Rhee, Ross-Larson, and Pursell 1984; Thomas and Nash 1991).

Doubts about their effectiveness have not reduced the attraction of various forms of government support schemes, for example, those for small and medium firms, which are popular all over the world. Other subsidy schemes are also widespread, and the evidence about their effectiveness is neither strong nor weak; however, some, such as special fiscal incentives for foreign direct investment or some agricultural support schemes in major OECD economies, tend to face somewhat more skepticism. This suggests that the drivers of support schemes actually have little to do with economic considerations and may mostly be part of the political give and take of any nation. In particular, the spread of best practices and more productive jobs upsets old patterns of production, typically disrupts the lives of some people while improving the lives of others, and in the end is the way to raise living standards broadly. Support schemes may therefore help good policy, because they may moderate the pain of adjustment and help build political backing for it; however, they may also help entrench vested interests and the survival of inefficient firms and thereby hold back productivity growth.

Insurance Schemes

Thus a major issue for policymaking is how to deal with demands for special support schemes. On the one hand, political acceptability may require such schemes. On the other hand, they must be designed in such a way that they do not undermine the workings of sound markets and the development of world-class capability in firms. While the politics of each country probably require somewhat different approaches, one general principle may be valid. As discussed earlier,

[8] This is the same as aid effectiveness where aid is successful when policy and institutional development are already on the right track.

the creation of successful ventures or firms requires taking risks. Experimentation is needed and failure is unavoidable. People are more likely to take risks when they know that they have some safety net to fall back on in case of failure. A sensible social safety net is therefore good for efficiency and growth, not just for equity and fairness. For example, the concept of limited liability, which limits business owners' losses, has helped promote entrepreneurship. Similarly, small farmers are more likely to invest in risky ventures when they have a way of insuring themselves against failure.

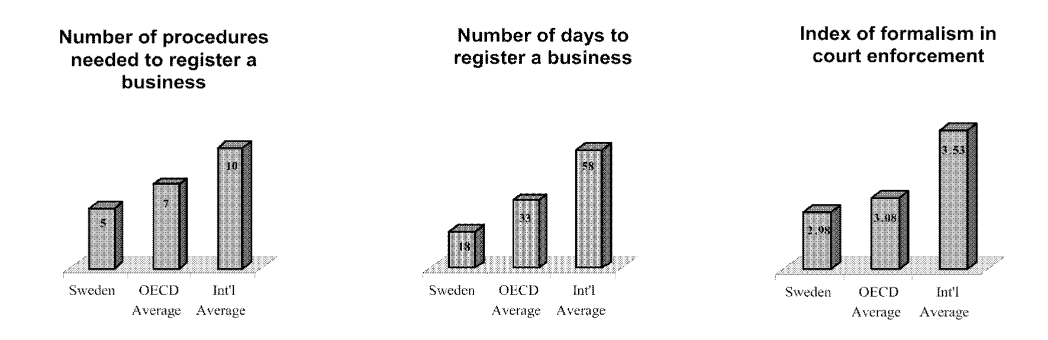
Political acceptability and economic efficiency may therefore be helped by designing forms of insurance appropriate for a particular economy. For example, industrial economies are likely to be able to afford large-scale unemployment insurance, while smaller insurance schemes are practical in poor countries. The latter schemes would include microfinance programs, which are mostly used not to fund investment, but to help deal with temporary inability to pay for consumption and spread the default risk among small groups of people (Morduch 1999).

The New Swedish Model

The general picture that emerges for desirable government policy might be termed the new Swedish model. Before the 1990s economists often saw Sweden's economic policy as a "third way" that fell somewhere between capitalism and socialism. After the economic crisis of the early 1990s, Sweden and several other Scandinavian countries remodeled themselves by combining the traditional emphasis on social security and safety nets with renewed emphasis on maintaining sound macroeconomic policies and a competitive business environment. The cornerstones of the current model are as follows:

- A set of prudent macroeconomic policies and low inflation (Dollar and Kraay 2000)
- A highly competitive environment for firms with few barriers to entry and growth and minimum red tape (figure 16)
- A strong social safety net.

Figure 16. Comparison of Regulation in Sweden with OECD and International Averages, 2002



Note: The index of formalism measures substantive and procedural statutory intervention in judicial cases at lower-level civil trial courts.
Source: Doing Business database (available at http://rru.worldbank.org/).

As countries develop, the complexity and average size of their institutions, be they firms, government agencies, or other forms of organizations, increase. The share of government in total economic activity also increases, not because the government interferes with production decisions and the ecology of firms, but because of the growth of the transfer payments that lie behind the social safety net of industrial societies. The new Swedish model, whether referred to as capitalism with a heart or socialism with a head, appears to be the main avenue ahead.

Partial and Heterodox Reform

The question remains how good governance in society at large arises and what can be done to promote it. A critical point is that we do not know how to engineer good governance. A plausible explanation is that pure chance and luck play a large role in the creation of successful societies (Easterly 2001). In addition, highly incomplete reforms have to be sufficient for growth to take off, otherwise no country would ever have developed. For example, countries like Bangladesh and China have seen progress, admittedly of varying degrees, by pursuing only partial reforms and despite continuing and pervasive governance issues. Many successful countries have pursued policy mixes that appear to be heterodox, like China, India, Japan, Korea, and Vietnam. Others, such as Chile and El Salvador, have successfully pursued relatively orthodox policies, again with varying degrees of success. At the same time partial reform and heterodox policies

may be associated with arrested development, as in the case of countries that unsuccessfully pursued import substitution. Likewise a heavy dose of orthodoxy has not by itself helped some countries, for example, in Latin America, to grow rapidly.

Creative Destruction

Successful development may also require the destruction of vested interests, that is, some form of revolution (Olson 2000). It can therefore be quite disruptive for some time, with unavoidable winners and losers. Arguably Germany, Japan, Korea, and Taiwan (China) all benefited to some degree from the disruption of war and from policies in part imposed by the United States after World War II. How much disruption is unavoidable and how much is excessive remains unclear.

Competition among Jurisdictions

Given the uncertainty about the exact mix of reforms and institutional change that makes for successful development, allowing experimentation with different mixes of institutional and governance reform must surely be valuable. The reason today's industrial economies exist is the industrial revolution that started in Europe. Competition among squabbling European states and principalities led to the world's growth miracle, termed the "European miracle" by historian Edwin Jones (Jones 1987). China, a previously advanced nation, was left behind as central control and the domination of mandarins over merchants arrested development.

Thus a selection mechanism is also important for the development of good governance, namely, competition among nations, or more generally, among various types of jurisdictions: across countries or across states within, for example, federal systems. Both for the firm and the government, a symbiosis of competition and rules-based cooperation seems to be required for complex societies to emerge and allow their citizens to prosper.

CONCLUSION

Effective wealth creation requires capable institutions. A complex symbiosis of competition and cooperation on the basis of accepted rules characterizes successful societies. We understand some of the basic measures required to establish such societies, for example, respect for property

rights and contracts and freedom for firms of all types to enter markets as well as to fail. Just as we cannot predict exactly which type of firm will succeed, so we cannot predict which type of government policy and institutional mix will be most successful. Competition among jurisdictions is as important to institutional development as that among firms. We have learned some basics about how to facilitate development, but we do not know how to engineer it and have to remain open to experiments. The hope is that we can improve the chances of success of unavoidable experiments by studying the way markets, firms, and governments interact in more detail (World Bank 2001b).

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PART II: DISCUSSION
PRIVATE SECTOR DEVELOPMENT: WHAT WORKS AND WHAT DOES NOT

Participants in the discussion following Michael Klein's presentation included Ahmed El Dersh, *Former Minister of Planning and International Cooperation*; Abdel Hamid Ibrahim, *Chairman, Capital Market Authority*; Abla Abdel Latif, *Policy Support Unit Manager, Industrial Modernization Program, Federation of Egyptian Industries*; Ahmed Galal, *Executive Director, ECES*; Anissa Hassouna, *Assistant General Manager, Research, Misr Iran Development Bank*; Galal El Zorba, *Chairman, Nile Clothing Company and Vice Chairman, ECES*; Ismail Siam, *Economist and SME Consultant*; Josse Dorra Fiani, *Chairman, Fiani and Partners*; Mahmood Ayub, *Country Director for Egypt, the World Bank*; Mustafa Kamel El Sayed, *Professor of Political Science, Faculty of Economics and Political Science, Cairo University*; Samir Radwan, *Managing Director, Economic Research Forum for the Arab Countries, Iran and Turkey*; Selim Al Teletly, *Executive Director, Industrial Modernization Program, Federation of Egyptian Industries*; and Tahany Shamloula, *Senior Economist and General Manager, Alexandria Branch, General Authority for Investment and Free Zones*. The following is a summary of the discussion.

Participant: I'd like to make two points. The first is about the role of the state. If you look at the Egyptian experience you will see that there is confusion between the need to promote the private sector and the desire on the part of the state to retain power. This confusion is what creates friction and prevents reform from going deeper. Could you elaborate a bit on the role of the state in this context?

The second point is that, as I understand it, you said resources and skills are important factors for growth but they are not the most important. I think skills are extremely important in explaining the low total factor productivity in the MENA region. This should not be underestimated.

Speaker: On the role of the state, it is important to note that a good institutional environment is characterized by various forms of regulation. None of what I've said argues against regulation. I only said make it simpler. What is important is the balance between cooperation and the need to weed out good from bad routines. The rules that govern all firms should leave room for competition because of the need for experimentation. Of course some may feel that the more rules you have the more control you exercise. In many cases the opposite occurs, you actually have more control when you simplify rules. Nowhere does this apply more than in the case of privatization of monopolies.

I would still argue that while skills are important, the big differences in levels of total factor productivity are not explained by skill differences. That is not to say that we should stop education, but from available evidence, Africa, for example, made relatively more progress in education than Asia over the last two decades. However, this was not reflected in overall economic progress. It's the institutional arrangements in countries that seem to matter more.

Participant: In your presentation there was not much discussion of the transition period, or a comparison between Egypt and other countries. In my view, the transition period is very critical because you must have harmony between different policies. You also need to have a plan and a clear sequence for transition. These all vary from country to country. So, what may work in Korea, Japan or China may not work in Egypt.

Speaker: There is no simple rule for transitions. The countries that came out of the former Soviet Union, for example, were all at the same point at the beginning of the transition. Yet, you have extremely different transition experiences among them. At one extreme, you have Estonia, which was an extremely orthodox economic policy experiment with highly-simplified rules and regulations. Now it is the best performing country of the former Soviet Union. At the other extreme, you have Uzbekistan, which has done very little in the way of reforms and has a highly autocratic oil-based economy. In between, you have Ukraine and Russia, performing in various

ways. This just reflects our lack of knowledge about what exactly is the right way of going about transitions. So, I agree that countries are always in transition, but I'm not sure that we have clear rules, regulations or ideas about what works and what doesn't.

Participant: Would you agree that there is a correlation between the investment climate and the failure or success of the privatization programs in different countries? Also, do you have some thoughts on the importance of privatization in the process of accelerating economic development?

Speaker: The success of privatization is clearly conditioned on the business environment. I want to distinguish between privatization in competitive sectors where you can have head-to-head competition and privatization in areas where there is a natural monopoly such as water, electricity and so on. In sectors where competition is possible and governments choose to introduce competition, then privatization pretty much always outperforms any other system. The most detailed reviews of the experience of the former Soviet Union and the Warsaw Pact countries show that privatization has never made it worse than before. In cases where there was no competition, privatization didn't make much difference. But in cases where there was competition and new entry and exit was possible, privatization has vastly outperformed the previous system.

The difficulty starts in the infrastructure areas. Private participation in infrastructure is complicated. In areas such as telecommunications, where you can have a reasonable amount of competition, most people would say that's the way to go. But when it comes to natural monopolies where competition is impossible, the quality of the regulatory environment is what matters. The issue here is the regulatory challenge and whether the company is in the public or private sector.

Participant: Let's agree on a definition of industrial policy. There is a very strong debate in Egypt about the concept of industrial policy and equating it with the identification of promising

sectors. Some say we need to concentrate our resources in the sectors that are seen as promising. The view at the Industrial Modernization Center is that this is dangerous. We don't have to select sectors as a whole. We have to select the promising enterprises within each sector. What is your view on this matter?

Also, you discussed the correlation between size and growth of SMEs. Do you see a future for SMEs in Egypt?

Speaker: What I mentioned was the particular type of industrial policy that uses tax subsidies, tariff protection and credit subsidies to support promising sectors. Everyone has a different view about which sector is promising, including those who are so-called experts at identifying what will prosper. One famous historical example is that in the 1900s in the UK, 25 percent of all employees worked in two professions – household servants and horse-related businesses. Then these professions disappeared and no one had a clue as to why, when or how, but clearly one has to be open to all sorts of new things. So creating an environment that is conducive to experimentation, allowing experiments to happen and allowing those that work to flourish, is what is necessary.

SMEs have a future and will always exist; this is the ecology of firms. What matters is that new firms are able to enter the market and challenge existing ones, where the new firms that are good actually become big, and where firms are big because they're good, not because they've always been big and have been protected. In any reasonably well-functioning market economy you will see that a large chunk of the economy is comprised of SMEs and among them there is a great deal of turnaround. Every year in a well-functioning market economy about 5-10 percent of all firms are new and have an average life span of 5 years. Some of them make it and some don't. This kind of ecology should be facilitated.

Participant: I believe that economic development is not a scientific but a natural process. Also, you said that it took decades to develop in Europe and other countries. Yet, you are talking about imitating them. How would you reconcile these two views?

In addition, I gather from your presentation that you are talking about the formal economy. But most developing countries are informal. Considering that the informal sector lacks a social security system, can I have your thoughts on how to adopt flexible labor policies?

Speaker: All countries started with an informal sector. The issue of informality is an issue of choice, people choose to be informal because the costs of becoming formal are high and the benefits from being formal are not attractive. The benefits from being formal are contract enforcement, property rights protection, access to finance, and so on. The costs of becoming formal are costs of business and customs administration, tax system administration, and so on. In all the countries we see making progress, as average firm size increases more informal companies become formal. This is achieved by making life easier for business and by giving greater benefits to formality.

I agree that economic development is not a scientific but a natural process. The analogy is that new species emerge and enter the market, which allows different species to interact. Letting that ecology flourish is precisely the point of having a good business environment. It takes time, but in more and more countries we see it is possible to do things faster than ever before. It is easier to adopt technology than to change social systems. In many different social systems it has been possible to adopt new technologies and working methods. I think the argument that one should have rigid labor laws because there is no social security is getting it the wrong way around. You need flexible labor laws to produce the wealth that allows social security to come about. Otherwise the wealth will never get produced.

Participant: If you were to give this lecture in other countries – such as South Africa, Brazil, Argentina, Pakistan – wouldn't you have said the same thing? I get the impression that this

presentation was prepared in the US and that you go to different countries, but say the same thing.

I also think you give us the impression that the private entrepreneurs are the good guys and the policymakers are the bad guys. Using the rules you've suggested, it is possible that policymakers could be the good guys and the private entrepreneurs could be the bad guys. Also, it is possible that the two of them could be good guys. But I'm worried that the two of them could be bad guys, where they both benefit from restrictions at the expense of the majority of people.

Speaker: *De facto*, I think most restrictions are there to protect the bad guys. I agree with you totally that there is nothing that says entrepreneurs are good and policymakers are bad, they're all people. Some of them are good and some are bad, that's not the issue. The issue is having a system of rules that puts checks and balances on the good ones and the bad ones alike. In economics the checks and balances are called competition and in policy they're called elections. The whole point of having a good business environment is to have rules under which people operate to prevent crony-capitalists from capturing the state. Is there a magical recipe for how to prevent that from happening? No there isn't, except to say that competition among firms is really a key mechanism to create innovation and keep the bad apples in check, so to speak. I agree that I would say this same thing in other countries.

Why are some countries having problems moving along that agenda? Is it stupidity? No, certainly not. Is it the quality of the individuals? Not necessarily. I think it's the way in which systems are designed. I don't have any recipes or specifics to say that's what truly varies between countries. However, I do think that the general principles that I've outlined apply across the world, but the way in which they are realized is very country-specific.

Participant: While I agree with you that the business environment is extremely important, I think that if it is not combined with a strategic vision for the country then the growth potential

that could be achieved from improving the business environment will not be realized. You could have a good business environment, but it won't matter if you don't know where the country is heading. I think we need a combination of both.

Speaker: On business environment, what is important is that what the government does is seen as credible and that people believe it is sticking to its policies. One could say that it is important to have a sensible market economy that combines social concerns with achieving production potential and so on. A vision at that broad level may make sense. However, I'm not sure one needs more detailed visions.

Participant: I agree with your comment that the institutional framework is more important than skills, because the lack of institutional framework could usurp any progress made by skilled persons. But I would like to point out a problem in developing countries as they try to adopt market-related policies. Sometimes policies are chosen on a selective or self-serving basis, so the process goes back and forth, momentum is lost, and progress is not achieved. The problem becomes more acute if you take into consideration that most developing countries are having economic difficulties, and the only way out is to accept a certain program that does not necessarily conform to their own system. This brings me back to the institutional problem. If you do not have institutions, even if you adopt such programs they won't work because successful institutional arrangements take a long time to build.

Speaker: This is the issue of the chicken or the egg. Somehow all sorts of countries have developed institutions even if they didn't have them at the beginning. We don't have recipes for how that works. I mentioned the example of some countries of the former Soviet Union. We know that partial reforms work, but we don't know exactly which partial reforms work well in which country. Bangladesh, for example, is not one of the most dynamic economies in the world, although these days it is doing reasonably well. A lot of its progress came from partial reforms around the textile sector. In other cases, governments have made partial reforms that have gone

absolutely nowhere. This is the big mystery. What can be done to create expectations in the business community that things are opening up and at the same time make use of what is actually there? One way forward on this, other than leaving each country to figure out, is to understand the process. The World Bank will not have the answer. We can have discussions about it, but there is no definite answer. The other way forward is to try to describe in more detail the reality of the business environment and see how we can develop different paths toward improvement.

What was the biggest progress in economic thinking in the 20th century? A good argument could be made that it was in macroeconomic policy, not only because Keynes and others came up with new ways of thinking about this, but because after WWII we created a system of national accounts and monetary and fiscal accounts. As you know, national accounts, which did not exist before WWII, have made it possible to conduct monetary and fiscal policy in ways that were inconceivable in the 19th century.

In the microeconomic area, you could probably find a good quote by Adam Smith for most of what I've said today. There has been no fundamental new insight in microeconomic policy for a long period of time. What would give us new insights? Either some incredibly clever people could come along or we could try to pile up statistics that capture microeconomic foundations of economies in ways that make them policy relevant. I believe that this is the big agenda. This is what all these measurement activities try to contribute to, whether these are exactly the right approaches or not, we'll find out.

Participant: What I liked about your presentation is that you tried to shift the discussion from characterizing the private sector as good or bad to focusing on the environment in which the private sector operates. A badly designed and managed business environment will produce a terrible private sector and vice versa. Now, I want to talk about three issues that I think are quite relevant for Egypt. They have already been touched upon, but I want to revisit them.

The first issue is industrial policy or the basic idea of picking winners and losers. The motivation for making this point is that Egypt has too many laws, restrictions and actions, which

suggest that someone believes that he/she can pick winners and losers. I wonder if you could elaborate on this point a little more, because I feel strongly that this is something we are paying a price for.

The second issue has to do with SMEs. Again, the discussion is not whether SMEs should exist or not. The point is whether they should be supported. Do we know, for instance, that these support programs, whether in the form of credit or something else, have worked elsewhere? Is there a systematic assessment as to whether the benefits from supporting SMEs have outweighed the costs of supporting them? And what would be the best way of doing that? It seems to me that the position you are taking is that if you get the environment right then everyone will do as well as they possibly can, which is not the current practice in Egypt.

The third and final issue relates to the informal sector. You seem to be taking the position that reforming the formal sector will persuade the informal sector to become formal. While this is true in part, additional reforms may be needed to address some of the specific problems related to the informal sector. This point is particularly important given that the informal sector accounts for one-third of GDP.

Speaker: In most countries there are all sorts of arguments about why particular types of sectors, enterprises or technologies should be supported. One way of viewing this whole issue about industrial policies and SMEs is to realize that. There is always someone who thinks small firms should be supported because they're small, they have potential, employ many poor people, and so on. Then there are people in the same country that say large firms need to be supported because of new technology or sometimes foreign investors. Then we need support for agriculture because that's the traditional sector. Then we need support for innovation and new technologies. When you add it all up, typically a support argument is made for just about everything. So how can we sort this out?

On industrial policy, I think this notion that you can pick winners and losers strikes me as plain wrong. Of course, it will be the case from time to time that government officials could have

just as good an idea as a private sector official. But just as people in the private sector are not necessarily good at picking the right bets, there isn't any assurance that those in government will do any better. In the case of government, they are working with taxpayers' money and the incentives to sort out good from bad bets tend to be a bit weaker. There are several examples in different countries. In Germany, they have the Maglev train. The government keeps pouring tax money into this project that doesn't make any economic sense. In Britain they have the Millennium Dome, heralded as this great project that would make money and it tanked immediately. One of the good things that had a low rate of economic return was the Eurotunnel because the government hadn't invested so much in it. Most of the losses were borne by private investors, which is how it should be. In that sense, I don't see why one would want to engage in picking winners and losers.

There may be an argument to establish special economic zones if it is a way of introducing a good business environment in a certain part of the country. If it's politically not feasible to reform the whole system, it may be useful to develop special economic zones. Not in the spirit of favoring a particular industry in that zone, but favoring a certain set of conditions – of liberalizing, deregulating and simplifying the law – which may help the business environment.

When it comes to SMEs what evidence is there about whether active support of SMEs in the sense of credits: cheaper credit, directive credit, guarantees systems and so on, is beneficial? One notable fact is that in both OECD countries and in developing economies there are very few evaluations of SME support schemes. That's the number one fact. They're always politically attractive but they're very seldom evaluated. When they are evaluated, it is usually after the money made available has been dispersed or the guarantees have been used. Then there are evaluations which ask: have some benefits been achieved, do these firms exist, have they received training, have they created jobs, and so on. These evaluations are mixed and in particular, they don't tell us how these firms would have done without the support. There are very few studies that have seriously tried to test whether these firms have done better with the support than without. There are a few cases, where they haven't done better. If there is any

pattern that emerges from these studies, it is that when the business environment in general is okay, then support to SMEs tends to be ultimately allocated not too badly. But under a bad business environment, giving special support to SMEs tends not to work.

Participant: There is a general consensus in Egypt about the need to implement change in the business environment and that is one of the major – if not the major – impediments to the development of Egypt's potential. Change has to be implemented by people. The issue is what to start with first. Do you reform people first in order to implement reform?

Speaker: We need good institutions but how do we get them when we don't have them? We need good people but how do we get them when we don't have them? I think that these questions are specific to each society. I don't have an answer to this.

Participant: I would like to ask you about a sort of catch-22 issue. Early in your presentation you put a very high premium on the price of intelligence. In Egypt, we probably have one of the most depressed wage rates in the developing world. This has led to brain drain and a disincentive for people to be productive. Is there a way to deal with this?

Speaker: From the bits and pieces I know about Egypt, a lot of people have come out the country reasonably well educated. The question is how one unleashes more of that potential. The world has unleashed a lot of human potential over the last century and every country has that potential. It all goes back to the basics. Do the environment and institutions allow people to realize that potential? I think in particular, and in this region also, women have a lot more potential than is being realized. Allowing that to happen is what matters.

Participant: Given recent developments in internal and external competition, in your opinion what are the most important factors that the government and policymakers must focus on to develop and achieve a more efficient private sector?

Speaker: When you compare development over time, Egypt has made progress. What exactly is the mix of measures in Egypt today? I don't know. However, the numbers I'm seeing evoke those of countries where competition in industry and service and in the economy more broadly, may be less than what it could be. My impression is that this may be the result of barriers to exit in particular.

Participant: I feel that the discussion is a little unfair to SMEs because we are focusing on support to SMEs. The key question in most cases with SMEs, not only in Egypt but worldwide, is that there are too many hindrances against them. The question is not about giving them additional support but rather removing the barriers that exist.

Also, I'd like to discuss the table in which you show that the output of immigrant workers in the US is higher than their output in their own country. I ask myself whether you're looking at a biased sample, in the sense that those who leave the country are more enterprising to begin with.

Speaker: On the SMEs, I agree. On the skill levels, the study I referred to was the first study that tried to control as much as possible for different variables, including education levels. However, there may still be some selection bias.

Participant: As I understand, the goal of this presentation is to help developing countries overcome the difficulties they face in privatization. I think the main issue is how to raise efficiency and you already referred to this. But what is efficiency specifically?

Speaker: In terms of the purpose of the presentation, we were trying to think about economic development and how it happens, not just for developing countries. I would make very similar remarks if I had to say something in Germany, for example, because some of the economic agents are equally relevant. Obviously, this focus on the business environment leaves out very

important fundamentals, like the existence of civil war or conflicts, which matter a lot more in some countries. This is an appropriate focus for countries where civil war is not an issue, where the macroeconomic situation is basically under control, and where the business environment issues come to the forefront.

As for the concept of efficiency, basically it is all about income and wealth generation. But income and wealth generation is not all there is to life. I agree that social and other phenomena are important to the economy. However, I don't know that we are in a position to have a big plan. I think one of the interesting things to note is that those countries that in my opinion have achieved some of the most interesting combinations of social protection and economic wealth, such as the Scandinavians, are countries that have applied some of the approaches I've talked about. So at least it gives hope that social protection and economic wealth creation can be compatible in a sensible way.

Participant: I would like to get your opinion about the transition from a situation where you have no policies, bad policies or confused policies to a situation where you have the right policies to induce progress. What triggers this kind of transition? Is it destroying the whole system and paving the way for a new one? Or is it getting someone like Margaret Thatcher, with a sort of religious belief in the private sector, to push forward without looking back? Or is there a process through which this can be achieved without an abrupt change in the regime? Could you comment on what's happening in other countries?

Speaker: Imagine the oldest living people in Germany today. They were born just around the turn of the 19th century. They grew up with a system that had been put in place in 1815 at the Vienna Congress, and were used to emperors and kings and all of that. If you had asked them at the time what they thought would happen to Germany over the course of the next century, could they have possibly come up with what happened? There was WWI, failed socialist experiments, fascism, WWII, then suddenly economic boom and democracy. There is no way anyone could have predicted this. So we do know *ex post* that in some cases economic structures have

benefited from massive destruction. We know in other cases that piece-by-piece improvements have worked. The success of the UK was relatively unrevolutionary throughout history compared to these massive destructions. We see that the Chinese experience after Mao and the Vietnam experience was rather gradual after all these major changes. Were these major changes necessary for that gradualism to work? We have no idea.

Is a Margaret Thatcher figure necessary? In Germany, we used to pride ourselves on our social system of collaboration between trade unions, political parties, the churches and so on and our ability to work things out. The system did work for a while. Now, more and more people are saying we need a German Thatcher, because it seems so difficult to make any changes. Maybe we'll need it and maybe we won't, who knows.

Moderator: On the industrial policy issue you said Japan and Korea have accomplished more than anyone else. Then you say that the contribution of industrial policy to growth is not very important. I'd like you to explain that. Also, is it possible to set priorities based on the most promising sectors without discriminating? If there is an initiative or development in a certain sector I'd imagine the government would respond. But with the limited resources of the government, do you still think that it is a good policy to set priorities based on criteria such as job creation or export-led growth in certain sectors? In Japan and Korea they've achieved growth with severe protection of their domestic markets.

Speaker: The best case that anyone can make for industrial policy is to say look at Korea and Japan. If any countries have achieved something with industrial policy, they have. As soon as you look at other countries, like the UK for instance, you have too many failures such as Concorde. So the question is, *ex post*, in the best case, what is the maximum contribution we can calculate from the protection that you mentioned? The studies that try to break down in detail which sectors grew, which ones benefited and what was the benefit, reveal a probable positive effect of industrial policy, but overall it has made only a very small contribution to growth. So the big argument is not industrial policy in the sense of picking winners. I don't think that anyone

is good at picking winning sectors. Politically, it is often necessary to proceed with improvements in the business environment on a somewhat sectoral basis. In some countries special economic zones may be the first step to introducing a new regime and then expanding it toward other areas. In other countries some sectors are liberalized or are deregulated, as were garments and textiles in Bangladesh. Then the lessons from that will slowly expand to other sectors. It may be politically necessary to have a certain sectoral focus in the way policymaking is conducted because you can't get everything done at the same time. There is no recipe for that. It will be country-specific and driven by politics rather than by a technocratic argument about which are good sectors and which are bad. Typically, industrial census statistics or national accounts show that the fastest growing sectors tend to be in the other category, the firms that are currently small, and have yet to flourish.

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According to Michael Klein, poverty reduction is about bringing economic growth to poor areas. Because poor areas can benefit from technical and organizational innovations made elsewhere in the world, it is possible today to create productive jobs faster and in greater quantity than ever before.

The puzzle is what helps spread such "best practices." Saving, investment, education, resources, and new technology are all needed – and fairly easy to obtain. What is hard to obtain are the institutions that allow these factors of production to be combined and translated into productive job creation. Firms are the key vehicles that spread best practices and productive jobs to areas where poor people live. Because we can never be sure which firms will be successful, it is necessary that new firms can enter markets, that substandard firms are allowed to fail, and that good firms face few barriers to growth. This is the definition of competition, and competition is what selects good firms and thus drives the spread of best practice and productive jobs.

Governments need to provide the framework, in which capable firms can emerge. Yet, the right mix of state activity and how it best interacts with firms are not fully understood. Some selection mechanism, which allows for policy experiments and selects successful ones, is valuable for national, provincial, and local governments. Thus competition among jurisdictions and firms is an integral part of dynamic social systems that hold promise for creating wealth and ending poverty.

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